

DOCKET SECTION

BEFORE THE
POSTAL RATE COMMISSION

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DOCKET NO. R97-1

**ANSWER OF UNITED PARCEL SERVICE WITNESS
J. STEPHEN HENDERSON TO INTERROGATORY OF
UNITED STATES POSTAL SERVICE
(USPS/UPS-T3-4 through 5)**

(February 11, 1998)

Pursuant to the Commission's Rules of Practice, United Parcel Service ("UPS") hereby serves and files the responses of UPS witness J. Stephen Henderson to interrogatories USPS/UPS-T3-4 through 5 of the United States Postal Service

Respectfully submitted,


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Attorney for United Parcel Service

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**ANSWER OF UNITED PARCEL SERVICE
WITNESS HENDERSON TO INTERROGATORY OF
UNITED STATES POSTAL SERVICE**

USPS/UPS-T3-4. Based on your experience with market-based pricing requests before FERC, please identify and discuss fully the non-cost factors regulators should consider when reviewing or recommending new rates, particularly when the regulated firm is exposed to direct competition by an unregulated firm. Include in your discussion your opinion regarding how often these non-cost factors should be re-examined and reconsidered.

Response to USPS/UPS-T3-4. My experience at the Federal Energy Regulatory Commission leads me to conclude that regulators can employ two broad approaches, not mutually exclusive, to protect the public interest when a regulated firm is subject to competition from an unregulated firm. These are the adoption of structural remedies and the use of traditional cost-based regulation. Structural remedies include vertical separation and the functional unbundling of the business components of the vertically integrated firm, which could involve the separation of monopoly elements from competitive elements, open access to the monopoly portion of the regulated business so that competitors cannot be foreclosed, codes of conduct governing the provision of monopoly services to the regulated firm's competitive functions, and so on. Traditional cost-based regulation includes ensuring that prices cover the relevant costs, providing for transfer pricing standards between business units or affiliates, and so on.

In recent years, FERC has adopted a policy of encouraging or requiring structural measures that allow competitive markets to develop in the non-monopoly sectors of the electricity and natural gas industries. Principally, this has involved rules governing open access to the electricity transmission system and the interstate natural gas pipeline system, i.e., open access to the monopoly sectors. Such structural

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measures are generally considered to be more effective in protecting the public interest and preventing cross-subsidy than cost of service regulation by itself.

A second lesson from my experience at FERC is that regulation must be governed by the regulator's statutory authority and the requirements of the legislation it administers. I am not a lawyer, but I nonetheless found it necessary to study FERC's enabling statutes in some detail. The Postal Reorganization Act similarly directs and constrains the Commission's regulation of the Postal Service. Because of the differences in the regulatory statutes, postal regulation is different from the regulation administered by FERC. For example, the Postal Rate Commission must be guided by the pricing factors in the Postal Reorganization Act, which differ from the statutory guidance provided to FERC. Moreover, some subclasses of mail are given a preference according to the postal statute. In such circumstances, the Commission's ability to make structural recommendations to the Postal Service may be more limited than FERC's ability to impose structural reform. Nonetheless, the Commission may have opportunities in this regard, although my testimony does not address the issue. To the extent that competitive services can be isolated from the monopoly service of an enterprise in such a way that the monopoly service provides no advantage to the incumbent in competitive areas, the need to rely on cost-based regulation will be reduced and competition can be encouraged.

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USPS/UPS-T3-5. Please provide a complete list of all books, scholarly publications, studies, or articles which you have authored.

Response to USPS/UPS-T3-5. See Attachment A.

USPS/UPS-T3-4 (Insert question here)

My experience at the Federal Energy Regulatory Commission leads me to conclude that regulators can employ two broad approaches, not mutually exclusive, to protect the public interest and to control for the potential of cross subsidy when a regulated firm is subject to competition from an unregulated firm. These are structural remedies and traditional cost-based regulation. Structural remedies include vertical separation and the functional unbundling of the business components of the vertically integrated firm, which could involve the separation of monopoly elements from competitive elements, open access to the monopoly portion of the regulated business so that competitors cannot be foreclosed, codes of conduct governing the provision of monopoly services to the regulated firm's competitive functions, and so on. Traditional cost regulation includes ensuring that prices cover variable costs or long-run incremental costs depending on the time period of the service offering, providing for transfer price standards between business units or affiliates, and so on.

In recent years, FERC has adopted a policy of encouraging or requiring structural measures that allow competitive markets to develop in the non-monopoly sectors of the electricity and natural gas industries. Principally, this has involved rules governing open access to the electricity transmission system and the interstate natural gas pipeline system, i.e., open access to the monopoly sectors. Such structural measures are generally considered to be more effective in protecting the public interest and preventing cross subsidy than cost regulation by itself.

A second lesson from my experience at FERC is that regulation must be governed by the regulator's statutory authority and the requirements of the legislation it administers. I am not a lawyer, but I nonetheless found it necessary to study the FERC's enabling statutes in some detail. The Postal Reorganization Act similarly directs and constrains the Commission's regulation of the Postal Service. Because of the differences in the regulatory acts, postal regulation is substantially different from the regulation administered by FERC. For example, the Postal Rate Commission must be guided by the pricing factors in the Postal Reorganization Act, which differ from the statutory guidance provided to FERC. Moreover, some subclassess of mail are to be given a preference by the Commission according to its statute. In such circumstances, the Commission's ability to make structural recommendations to the Postal Service may be more limited than FERC's ability to impose structural reform. Nonetheless, the Commission may have opportunities in this regard although my testimony does not address the issue. To the extent that competitive services can be isolated from the monopoly service of an enterprise in such a way that the monopoly service provides no advantage to the incumbent, the need to rely on cost based regulation will be reduced and competition can be encouraged.

USPS/UPS-T3-5 (Insert question here)

ATTACHMENT A

CURRICULUM VITA

February 1998

J. Stephen Henderson

Principal

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Education

B.S. International Affairs

1965 U.S. Air Force Academy

M.A. Economics

1966 Georgetown University

M.S. Economics

1971 University of Wisconsin

Ph.D. Economics

1975 University of Wisconsin

Professional Experience

Principal, Putnam, Hayes & Bartlett, Washington, DC, October 1996 - present.

Associate Director for Electricity, Office of Economic Policy, Federal Energy Regulatory Commission, August 1993 - September 1996.

Deputy Associate Director for Electricity (1991 - 1993), Special Assistant (1989 - 1991), Office of Economic Policy, Federal Energy Regulatory Commission.

Senior Institute Economist, National Regulatory Research Institute, 1982 - 1989.

Economist, Office of Economic Policy, Federal Energy Regulatory Commission (On Leave of Absence from NRRI), January 1988 - June 1988.

Assistant Professor of Economics, Ohio State University, 1975-82.

Instructor, Quantitative Studies Department, School of Systems and Logistics, Air Force Institute of Technology, 1971-1975.

Economist, Personnel Analysis Division, Headquarters U.S. Air Force, Pentagon, 1966-1969.

Military Service U.S. Air Force Cadet 1961-1965, Officer 1965-1975

Research Areas The Economics of Public Utility Regulation and Applied Microeconomics

Teaching Areas Public Finance, Microeconomics, Statistics, and Economic Regulation

Papers

"Market-Based Pricing of Wholesale Electric Service," (with Bernard Tenenbaum) *The Electricity Journal*, December 1991.

"Natural Gas Prices and Contractual Terms," (with Anand Desai) *Energy Systems and Policy*, December 1989.

"Price Discrimination Limits in Relation to 'Death Spirals'", *The Energy Journal*, July 1986.

"The Effect of Regulation on Nonuniform Electricity Price Schedules in the U.S.," *The Journal of Public Economics*, June 1986.

"Cost Estimation for Vertically Integrated Firms: The Case of Electricity," in Michael Crew (ed) *Analyzing the Impact of Regulatory Change in Public Utilities*, Lexington Books (Lexington, MA: 1984).

"The Economics of Electricity Demand Charges," *The Energy Journal*, Special Electricity Issue, December 1983.

"Costs and Benefits of Residential Time of Use Metering: Comment," *The Energy Journal*, January 1983.

"Bargaining Costs and Regulation Induced Cost Distortions," *The Journal of Public Economics*, February 1982.

"Stochastic Optimal Control of Internal Hierarchical Labor Markets," *Journal of Optimization Theory and Applications*, January 1980.

Papers in Conference Proceedings

"Securing the Reliability and Efficiency of the Bulk Power Grid," Twenty-Fifth Annual Williamsburg Conference, Williamsburg, Va, December 1993.

"Fostering the Transmission Grid Needed for a Competitive Power Market," Twenty-Fourth Annual Williamsburg Conference, Williamsburg, Va, December 1992.

"The Commission's Transmission Pricing and Access Policy," Eighth Biennial Regulatory Information Conference, NRRI, September 1992.

"There Are No Distortions of Short-Term Generation Choices if Electricity Transmission Is Priced Flexibly," Sixth Biennial Regulatory Information Conference, NRRI, December 1988.

"Pricing the Transmission of Electricity," Nineteenth Annual Williamsburg Conference, Williamsburg, VA, December 1987.

"An Economic Perspective about Price Discrimination in Public Utility Regulation," Thirteenth Annual Rate Symposium, St. Louis, MO, February 1987.

"Evaluating Price Discrimination Using a Simple Social Welfare Model," Fifth NARUC Biennial Regulatory Information Conference, NRRI, December 1986.

"Estimating Short Term Cost Functions for Electric Utilities," Fourth NARUC Biennial Regulatory Information Conference, NRRI, December 1984.

"Electric System Load Patterns and Demand Charges", in *The Economic Impact of Energy Conservation*, Volume III, U.S. House of Representatives Committee on Science and Technology, U.S. Government Printing Office, December 1978.

Reports

The Transmission Task Force's Report to the Commission -- Electricity Transmission: Realities, Theory and Policy Alternatives, (with W. Booth and J.S. Herod) Federal Energy Regulatory Commission, October 1989.

An Economic and Legal Analysis of Undue Price Discrimination, (with Robert Burns) National Regulatory Research Institute Report 89-12, August 1989.

Natural Gas Producer-Distributor Contracts: State Regulatory Issues and Approaches, (with J.M. Guldman, et al.) National Regulatory Research Institute Report 87-12, February 1988.

Some Economic Principles for Pricing Wheeled Power, (with Kevin Kelly) National Regulatory Research Institute Report 87-7, August 1987.

Natural Gas Industry Restructuring Issues (editor), National Regulatory Research Institute Report 86-8, September 1986.

Time-of-Use Electricity Pricing in Ohio, (with Robert Burns, et al.) Final Draft Report to the Public Utilities Commission of Ohio, September 1986.

An Economic Analysis of Block Billing for Natural Gas, National Regulatory Research Institute Report 86-5, March 1986.

Natural Gas Rate Design and Transportation Policy Under Deregulation and Market Uncertainty, (with J.M. Guldman, et al.) National Regulatory Research Institute Report 85-15, January 1986.

Regulating Electric Utilities with Subsidiaries, (with Robert Burns, et al.) National Regulatory Research Institute Report 85-16, January 1986.

A Decision Support System for Utility Performance Evaluation, (with Luc Anselin) National Regulatory Research Institute Report 84-15, April 1985.

Cost-of-Service for Intrastate Jurisdictional Telephone Service, (with William Pollard) National Regulatory Research Institute Report 84-13, April 1985.

Commission Regulation of Small Water Utilities: Outside Resources and Their Effective Uses, (with Vivian Davis, et al.) National Regulatory Research Institute Report 84-7, August 1984.

State Regulatory Options for Dealing with Natural Gas Wellhead Price Deregulation, (with Kevin Kelly, et al.) National Regulatory Research Institute Report 83-7, August 1983.

Funding Nuclear Power Plant Decommissioning, (with Robert Burns, et al.) National Regulatory Research Institute Report 82-3, October 1982.

The Need For Natural Gas Storage in Ohio, (with Daniel Czamanski) Report to the Federal Energy Administration, September 1977.

Electricity Pricing Policies for Ohio, (with Daniel Czamanski) Report to the Public Utilities Commission of Ohio, September 1976.

Current Practices and Economic Principles of Regulated Pricing, (with Kevin Kelly) Report to the Public Utilities Commission of Ohio, June 1976.

Optimal Control of a Manpower Hierarchy with Demand Uncertainty, Ph.D. Dissertation, University of Wisconsin, 1975.

DECLARATION

I, J. Stephen Henderson, hereby declare under penalty of perjury that the foregoing answers are true and correct to the best of my knowledge, information, and belief.

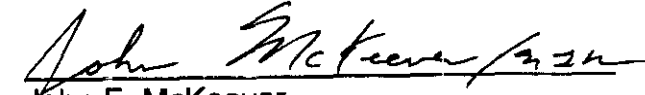


J. Stephen Henderson

Dated: February 10, 1998

CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document in accordance with section 12 of the Commission's Rules of Practice.


John E. McKeever

Dated: February 11, 1998
Philadelphia, PA